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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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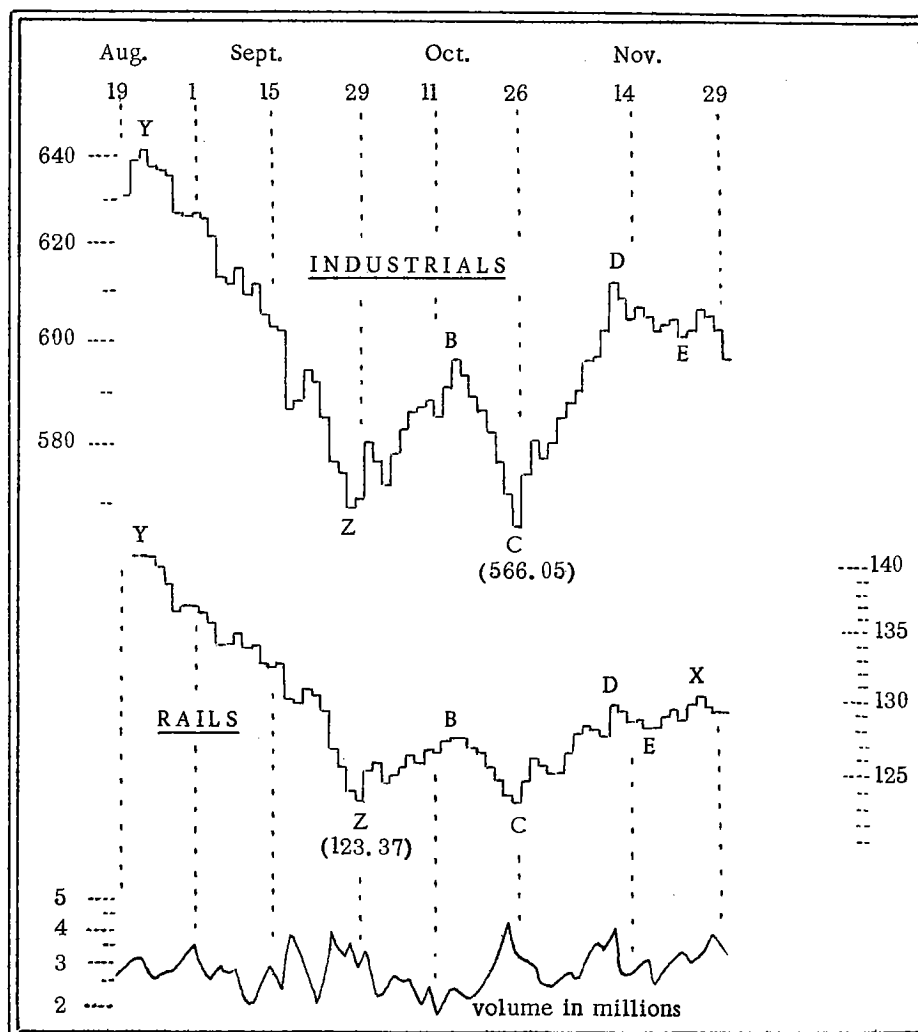
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PRICE MOVEMENTS Price action over the last few months has been exasperating to both bulls and bears, but veteran market observers eventually learn to accept the "unexpected" as commonplace. Unfortunately, I do not control or influence the market. If I did, readers can rest assured that I would make the price action a good deal easier to "read". As it is, I merely follow the Averages, my job being to interpret the price movement to the best of my ability.

A most interesting situation has now developed. Since the D points, Rails have evidenced rallying tendencies while Industrials have shown signs of wanting to go down. When this type of divergence occurs after a sharp rally it often spells danger. On November 23 the carrier Average bettered its D level (see chart), following which Rails advanced to point X (130.13). On the same move, however, Industrials stubbornly refused to confirm by bettering their own D point (612.01). Since, under Dow Theory, a penetration of one Average unconfirmed by the other is considered meaningless, I assume that readers did not leap to bullish conclusions based on the Rail bettering of D.

On November 30 Industrials violated their preceding decline low at E (601.10). Thus the senior Average dropped to its lowest level in three weeks, and by so doing formed a rather pronounced downward zig-zag. As of this writing Rails have not confirmed the Industrial weakness, and the carrier Average has held above its preceding low point at E (128.39).

A joint bettering of the recent highs (D on Industrials, X on Rails) would signify a continuation of the secondary (upward) trend. Conversely, if Rails violate E (128.39) on increasing volume it would strongly suggest that the secondary trend had turned down. The odds would then favor a "testing" of the bear market lows (Industrials at C - 566.05, Rails at Z - 123.37). A penetration of the C-Z lows would reconfirm the primary bear trend.



NOTE Ordinarily, accumulation takes place at or near the lows of a movement (investors like to accumulate at the most advantageous prices), while distribution usually takes place near the highs (investors like to distribute at the best possible prices). It is of interest that the sidewise pattern of the last few weeks has taken place near the highs of the C-D rally.

WATCH THE BIG PICTURE

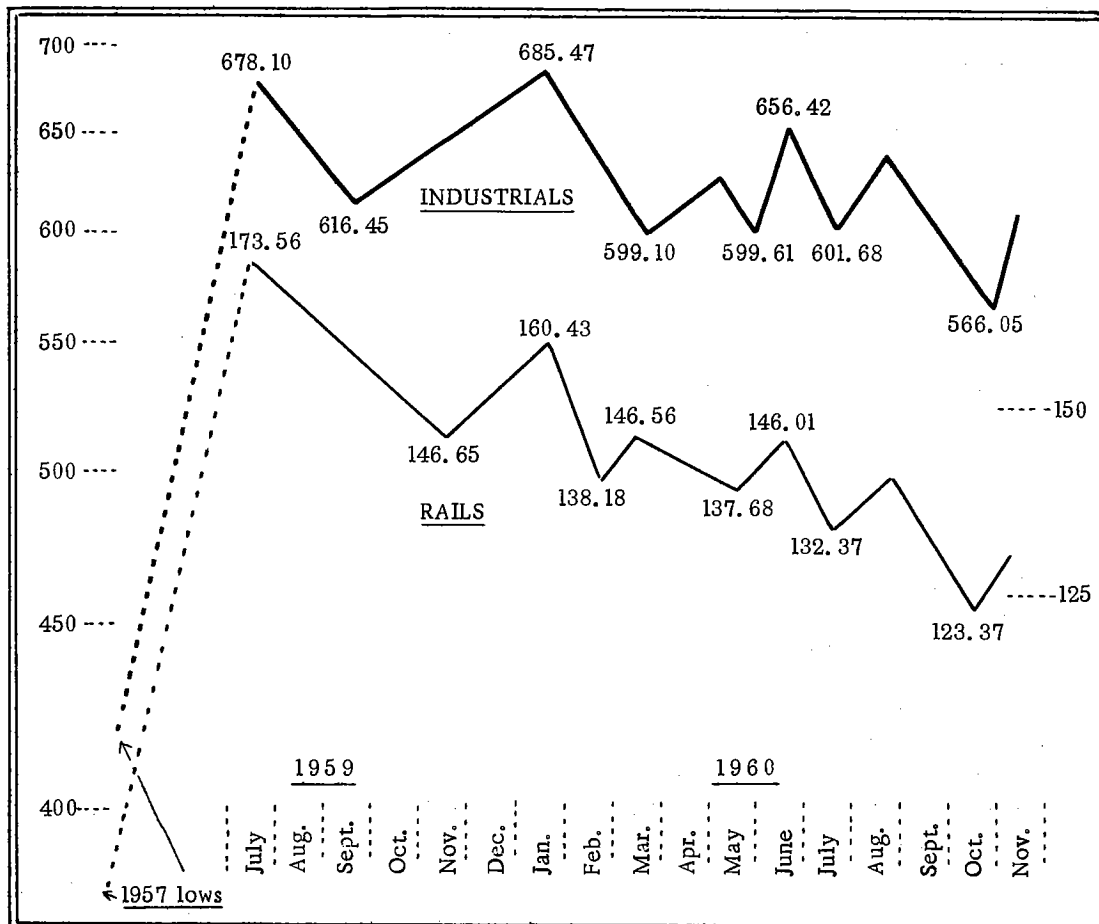
Periodically (particularly when the intermediate term picture seems confused), I find it helpful to review "the big picture". The accompanying chart shows the more important price movements dating from 1957 to the present.

The great third phase bull market advance of 1957-59 (dotted line) began at 419.79 for Industrials (October, 1957) and 95.98 for Rails (December, 1957). By July, 1959, Rails had reached a peak of 173.56; one month later Industrials touched a peak of 678.10. Hamilton always considered that a movement had ended at the point where the last confirmed highs (or lows) were recorded. For this reason Dow Theorists accepted July 8, 1959, as the date for the bull market's end.

Following the July-August peaks, the two Averages retreated. Industrials hit a low of 616.45 in September, 1959. Rails established their low two months later at 146.65. But the momentum of a ten year bull market (1949-59) is not easily arrested, as forthcoming events were to prove. During the last quarter of 1959 the Averages advanced sharply, and Industrials touched a new high of 685.47. This high was not confirmed by Rails; for this reason the bull market was not reconfirmed. Subsequently, a drastic sell-off occurred, and when, in March, both Averages violated their preceding lows to the accompaniment of heavy volume, Dow's Theory signalled a bear market.

Following the bear signal Industrials dropped to 599.10, Rails to 138.18. From these low a rather unusual series of events took place. Industrials embarked upon three separate rallies, recording peaks in April (1960), June and August. On the retreat from the April and June peaks the preceding 599.10 level held intact. On each rally, however, Rails refused to confirm by bettering their secondary high of 146.56 (established in March). Not only did Rails persistently refuse to confirm, but on each successive decline the Rail Average dropped to new lows.

This highly dangerous situation resulted in a final cracking of the 599.10 Industrial level, following which the two Averages sank to their most recent low points of 566.05 (October 25) and 123.37 (September 29).



Thus we have a bear market signalled on March 3, 1960, and a reconfirmation of the primary bear trend on September 19 as the 599.10 "triple bottom" was violated. Despite general complacency and the recent revival of bullishness, there is at present nothing in the pattern of the Averages or in Dow's Theory to suggest that the primary trend is anything but down.

THEN AND NOW There is an old French proverb which says: "Distrust that which is probable". With this thought in mind, it is interesting to compare today's market psychology with that of late 1957 and early 1958.

The average person tends to be more emotional than studious, and for this reason when danger arises he is likely to be influenced or guided by events of the most recent past. The public remembers that in July, 1957, a violent secondary reaction occurred, resulting in a drop of 100 points in the Industrial Average within a period of three months (July to October). An extended sideways movement ensued, lasting from October, 1957, to April, 1958, and this consolidation was followed by the great advance of 1958-59. Readers can probably remember the skepticism and disbelief which accompanied the 1958-59 rise. The majority of investors literally denounced the advance as some sort of "market madness". Others accused Wall Streeters of "manipulating" the market. "Going short" became the favorite occupation of the day (the 1958 short total hit 6 million shares), odd-lot selling and short selling were rampant, and against all this the market continued its relentless rise.

During 1958 and early 1959 nobody believed that the market was "saying something", and I can remember spending many hours arguing to the effect that every primary swing is justified by forthcoming events. Nevertheless, it was not until early 1959 that the mass bearishness finally exhausted itself. By that time the market had put the best and the safest part of the rise behind it.

Ironically, the situation is exactly reversed today. The same people who (in 1957) were saying that "the market has taken leave of its senses" are now saying that the sagging economy is just a temporary "adjustment" and that the stock market is predicting better things ahead. These people point to the rising short interest total, the odd-lot selling and the odd-lot shorting. "It's so simple," they insist, "1957 all over again."

All market systems are subject to interpretation. When a market indicator gathers too wide a following (see Letter 123, page 2) or where the interpretation of that indicator borders on the mechanical -- then experience tells us to "tread lightly". The technical approach to the market has now gathered its widest following in history. For this reason it seems to me that it should be followed with utmost care and even skepticism.

POPULATION EXPLOSION Over the last year I would guess that about one hundred people have taken the trouble to tell me about the population "boom". "An expanding population," they explain, "is practically a guarantee of continued prosperity." I then ask them about China and India. "Oh, that's different," they answer, "we're talking about the U. S. A."

The following statistics might be of interest to those who think that an expanding population is some sort of an economic "insurance policy".

Between 1810 and 1820 the U. S. population expanded 33%. Yet Dow wrote about "a tremendous contraction of bank circulation" and "a money panic" which occurred in 1819. He was referring to the general depression which followed the War of 1812.

Between 1830 and 1840 the U. S. population increased 36%. But Dow discussed "the great commercial panic" which followed the land boom of 1835-36 (in Dow's day the word "panic" was used to describe a bear market).

Between 1850 and 1860 the U. S. population increased 38%. "There was a panic of the first magnitude in 1857," writes Dow. "This panic came unexpectedly, although prices had been falling for some months. One of the features of the period was the great number of failures. The banks generally suspended payment in October."

Between 1870 and 1880 the U. S. population expanded 30%. Dow refers to events in 1873 as "... a commercial as well as a stock exchange panic. Business had expanded on an enormous scale, and the supply of money became insufficient for the demands upon it. Credits collapsed and the depression was extremely serious."

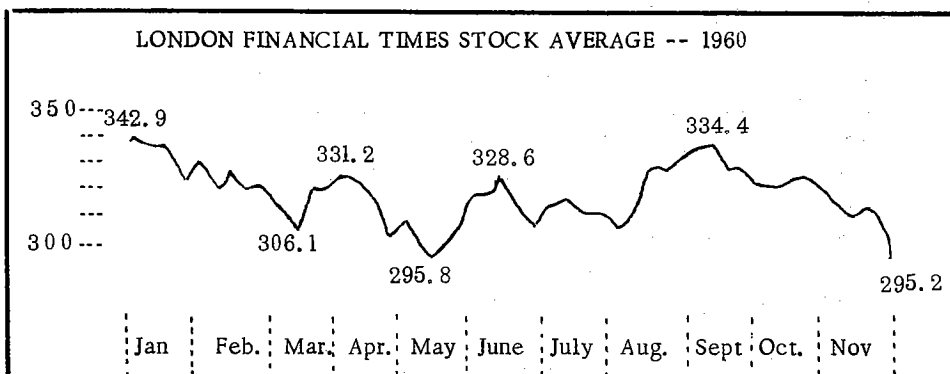
Between 1890 and 1900 the U. S. population expanded 21%. A severe bear market and business depression came in 1893

Between 1920 and 1930 the U. S. population rose 16%. This period requires no comment at all.

FOLLOW-UP ON INTERNATIONAL MARKETS (see Letter 124) Mr. J. F. Danson is a veteran Dow Theorist and perhaps the leading student of the London market. He and I have corresponded for some time. Because of the nationalization of the British rails Mr. Danson has had to develop his own "D Index" of fast moving or sensitive stocks, and this Index is used to confirm the movements of the London Financial Times stock average.

As seen on the chart, the Financial Times average touched a high of 342.9 on January 4, 1960. A decline carried that average down to 306.1 on March 3. The subsequent rally stopped at 331.3 (April 4), and on the next decline the Average decisively broke the preceding low of 306.1. The entire sequence was confirmed by the "D Index", and Mr. Danson therefore took it to signify that London had signalled a bear market.

A rather unusual secondary (upward) reaction began on April 5, and this advance carried to August 8, advancing the English average to 334.4. On August 24 a new primary bear leg got underway. I received a letter from Mr. Danson on November 18 which stated: "In London the D Index has re-confirmed the bear market but Industrials have not yet done so." Last week the bear market in London was reconfirmed as Industrials dropped sharply (November 28) to a new low of 295.2 (on heavy volume).



Simultaneously, on November 28, the Japanese stock market suffered its fourth selling wave of the year. Last week Italy's stock market responded sympathetically, as the accompanying newspaper clipping bears out. All of which underscores the world-wide import of primary movements.

STOCKS In Letter 118 (September 28) I called attention to the massive "head-and-shoulders" distribution formation in Bethlehem Steel. Since that time the stock has broken to new lows. Below is a weekly chart of Republic Steel, and here again we see a huge head-and-shoulders pattern. The stock appears to be headed much lower, and a closing of 50 or below would mean that it was on its way. I would not wait for 50 in order to put out shorts, however. RS can be shorted at the market.

NOTE: As of this writing (Thursday, December 1, 2:10 P.M.) I hear that Rails have broken below point E (128.39) on an intra-day basis. If Rails close below point E there is a strong probability that the secondary trend has turned down.

Milan Exchange Stocks at '60 Low

MILAN, Italy, Nov. 24 (AP). —Shares on Milan's stock exchange plunged to 1960 lows yesterday. Losses brought shares down as much as 50 per cent from the year's highs in September.

Financial circles blamed, among other things, the United States gold drain and uncertainty here about recent Wall Street activity.

The average loss of all stocks in yesterday's trading was 7 per cent. Mediobanca, one of Italy's largest investment banking houses, fell 20,500 lire to a closing price of 68,000, a loss of 23 per cent.

